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November 2019

AMBIT ASSET MANAGEMENT

Good & Clean Portfolio

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India: Repair and overhaul in progress

Dear Investor,

Although an environment of gloom and doom seems to dominate the current consumer sentiment, we believe India is on the (bumpy) path to progress. The slowdown we presently face in consumption and Investment is getting addressed by this government through decisive action over the last few months. There is an expectation that more steps to boost consumerism and investment in the economy will be in focus (foreign investments, protecting domestic interests). In the context of the Regional Comprehensive Economic Partnership (RCEP) trade agreement, bilateral discussions are expected in the near future itself as Indian negotiators fine-tune trade stance on important issues relating to surge in imports, future policy concessions and unequal tariffs. (especially in the context of Chinese imports).

Looking back: steps to encourage consumerism/ investments were deployed

1. Make in India helped FDI, ease of doing business boosted image

- The "Make in India" movement was launched on 25th September 2014. Its object was to encourage domestic and foreign companies to manufacture their products in India, with dedicated investments in manufacturing.
- One of the areas where reasonable success was achieved was FDI where there is an upward trajectory since FY14. FDI equity inflows have grown by 60.2% between FY10-FY14 and FY15-FY19.
- In 2019, India ranked 63rd among the chosen 190 countries in the World Bank's Ease of doing business index. India has jumped 79 places in the Doing Business rankings since 2014. Its object was to encourage domestic and foreign companies to manufacture their products in India, with dedicated investments in manufacturing.

2. Demonetization, GST: Bold steps to push formalization in the economy

- In November 2017 the Indian economy faced an all too well known upheaval and disruption on account of demonetization. While demonetization was a well-intentioned way to get higher investments (and tax collection) into India by bringing back black money into the formal economy, it crippled the heavily cash dependent Indian market. In the longer term however it has compelled many Indians to begin participating in the formal channels of the economy, curb corruption and push digitization.
- GST implementation in India has been a landmark tax reform tackling the tax complexity in India. The GST tax replaced nearly 15 states and federal taxes, increased transparency and reduced scope for corruption. GST has turned all 36 states and union territories of India into one common market. By curbing and cascading taxes, GST has also reduced the cost of local production and puts India in the line of international tax standards, making it easier for Indian businesses to sell in the global market.
- The above sequence of events set into motion a chain of events that temporarily slowed the largest demand components driving the Indian economy: Consumer expenditure and Investments.

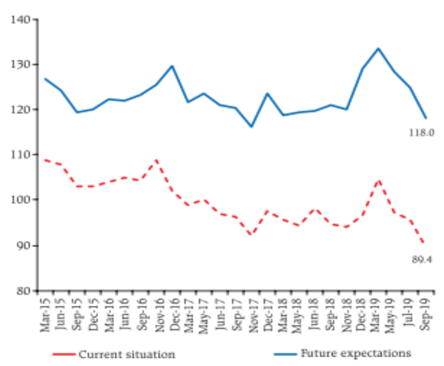
3. Short term pain felt, as it had a deeper impact than initially expected

- Despite the decisive steps however industries suffered due to initial complications around GST, increase in compliance costs under various laws, cash flows stuck in delayed IT and GST refunds, unwillingness of banks to give loans and an unresolved NPA crisis and stalled reforms.
- The April 2019 MPR* had projected real GDP growth of 6.8% for Q1FY20. The actual outcome for the quarter undershot the projections by 180bps. This was because:
  1. Private consumption demand fell short of expectations, as it underestimated the broad-based slowdown in both rural and urban consumption.

2. Gross fixed capital formation (GFCF) growth turned out lower than the projection on account of lower than expected capital goods production and imports, and moribund activity in construction.

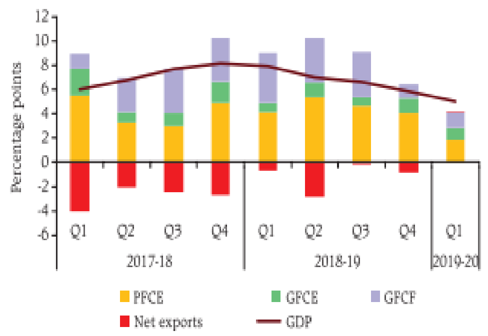
- Fast forward to 1QFY20, lo and behold GDP slowed to 5%, (slowest growth since 4QFY13 and down from 8% in the year-ago period, Ref Exhibit 3)

Exhibit 1: Consumer confidence survey for the year ahead continued its fall from May-Sep



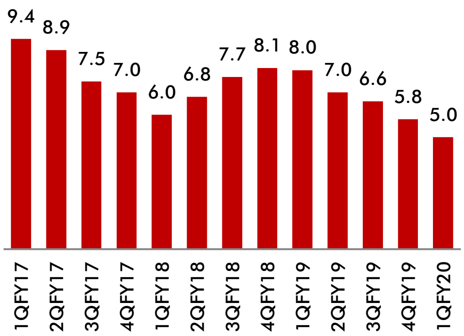
Source: Ambit asset management, RBI

Exhibit 2:Private capex (PFCE) has been falling



Source: Ambit asset management, RBI

Exhibit 3:GDP growth has slowed to 5%



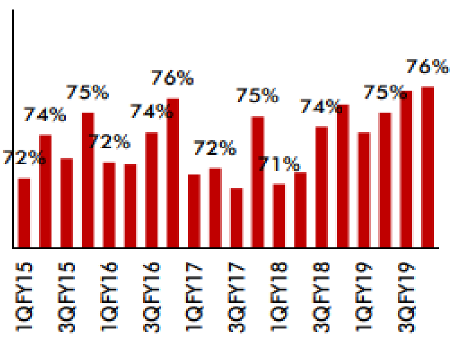
Source: Ambit asset management

Recent steps testimony to government focus on investing/manufacturing

Corporate tax announcement to bolster investment in due course of time

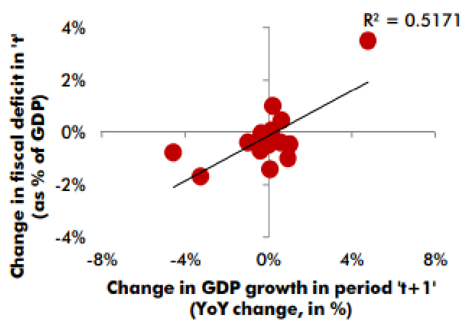
- As monetary policy space remains limited, more countries worldwide are adopting easier fiscal policy stances to bolster growth. For many economies (Like India), however, their ability to introduce large-scale fiscal stimulus measures is limited, given persistent fiscal deficits and elevated public debt levels.
- The tax cut announcement on 20th September essentially translates into a stimulus of Rs1.45trn, or 0.7% of GDP. This fiscal boost is likely to percolate into higher GDP growth with a lag as the existence of spare capacity (See exhibit 4below) will delay rapid translation of this tax boost into higher GDP growth.
- The tax cuts also help create an environment which is conducive to investments and investing in India as it brings the tax structure in line with other comparable investment destinations of the world which makes this all the more positive.

Exhibit 4:Capacity utilization rates are currently still low



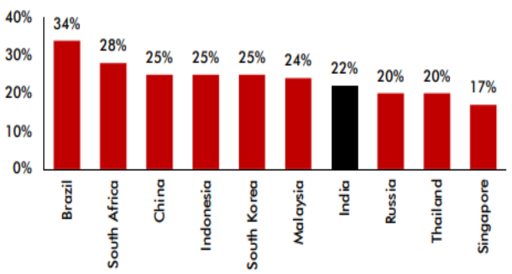
Source: Ambit Capital research

Exhibit 5:Fiscal stimulus is known to boost GDP with a lag



Source: Ambit Capital research, Data pertains to FY05-09

Exhibit 6:Indian corporate tax rates now one of the lowest amongst emerging economies



Source: Ambit asset management

Government finances may be impacted to bring about growth: Disinvestment and crude price will partly support

- Given the seriousness the government has shown in shoring up consumerism and investments, it is highly likely that government may be unable to meet its fiscal deficit target for the year. However higher disinvestment and low crude prices can be a silver lining at this juncture.

- The disinvestment target was revised upward from Rs900bn to 1.05tn. The government has shown its willingness to bring down its stake below 51% in certain public sector units. (refreshing change from its earlier stance)
- Crude prices have been supportive over the last few months and unlikely to rise significantly for the next 6-12 months given the global slowdown and the increase in US stockpiles. Crude remaining at these levels will benefit India given that every $10 per barrel increase in crude price leads to a $12-14 billion rise in current account deficit annually.

Next on agenda: Encouraging & protecting domestic manufacturing to start a virtuous cycle

1. Protectionism will support local manufacturing and spur growth

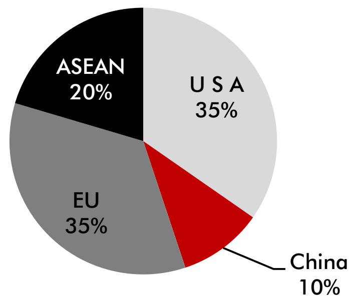
- A wave of anti-globalization has struck a chord with many countries and voters and has had bearing on events such as elections (France, USA), Trade policy (Specially US-China) and Brexit (Revoking EU market access and a form of protectionism) amongst others. The United States continues to pursue a USA first agenda in all its dealings including its position on trade with China. Similarly the UK first agenda was what culminated into a vote of confidence in Brexit.
- Given this backdrop countries like India, which over the years have been criticized for protectionist measures, may be able to get away with a lot more than earlier would have seemed possible. Nirmala Sitharaman already made a clear embrace of protectionism in her maiden Union Budget. (Source)
- In the preceding month the government has identified hundreds of products including electronics, toys, blankets and several daily-use items for possible "import substitution" by discouraging their shipments into the country, imposing higher duty, and specifying standards to meet or other WTO compliant safeguards. (Source)
- The above would have the following direct outcomes:
    1. This would provide support for local manufacturers in the form of import substitution.
    2. It would curb the threat to import of Chinese goods which have over the past few years hindered the Make in India push efforts. It would also curb dumping of unsold Chinese products to neighboring India given the US-China trade tensions. (Ref Exhibit 7)
    3. It would encourage global players present in India to directly manufacture in India given the tariff restrictions and added incentives to manufacture in India. (Ref Exhibit 8)
    4. The cumulative effect could be an improvement in the trade deficit and Balance of payments.

Exhibit 7:India's break up of imports from China, new tariffs can potentially impact plastics, electrical machinery/ equipment

Imports from China	FYTD (Apr-Aug(P))	FY19
Electrical machinery and equipment and parts	28%	29%
Nuclear reactors, boilers, machinery and mechanical appliances	21%	19%
Organic chemicals	13%	12%
Iron or steel goods, Iron & steel	5%	4%
Plastic and related articles	4%	4%
Fertilizers	2%	3%
Miscellaneous chemical products	2%	2%
Optical, photographic, cinematographic, measuring and medical	2%	2%
Vehicles other than railway or tramway rolling stock, and parts and accessories	2%	2%
Imports of top 10 categories	**79%**	**78%**
Total Imports from China ($mn)	**29,824**	**70,320**

Source: Ambit asset management, Department of Commerce (Data Bank)

Exhibit 8:India- share of exports for FYTD Apr-Aug (P), US is an important export market and would see big potential to grow given US-China trade war



Source: Ambit asset management, Department of Commerce (Export Import Data Bank)

2. Steps being taken to bring back Foreign investments

- Earlier in August the cabinet approved a slew of changes to the country's foreign direct investment (FDI) norms including new norms for single-brand retail. The government has also permitted 100% foreign investment in coal mining and contract manufacturing, besides allowing 26% FDI in digital media firms.
- Post the fiscal stimulus measures (September 20th) to boost market confidence FIIs have bought Indian equities worth $1.04 billion in September, the highest monthly inflow since May. This follows an aggressive sell-off to the tune of $4.13 bn in July; August followed a sell-off to the tune of $4.13 bn in July, August.
- Given the trade tensions between US-China, it is likely that US invests in India and Indian manufacturing, meeting some of its trade needs through investment/imports into/from India. U.S. imports from China totaled $539.5bn in CY18 which is greater than India's global exports at $330.1bn in FY19. The top import categories by US from China (2-digit HS) in CY18 were: electrical machinery ($152bn), machinery ($117bn), furniture and bedding ($35bn), toys and sports.
- Driven by incentives for manufacturing in India, trade tensions in China and strong local manufacturing, companies are benefitting. In this context Apple plans to begin export of 'Made in India' iPhones across the world to avoid a 20% duty. It is very likely that others could follow suit given the recent follow on announcements by the Finance minister encouraging investments in manufacturing.

"It (India) is one of the fastest growing (economies) even today. It has the best skilled manpower and a government that is continuously doing what is required in the name of reforms, above all democracy and rule of law works and there are a lot of reforms happening, even those to cut down delays.

So you will not have anything better... democracy loving, capitalist respecting environment... in India"

–FM Nirmala Sitharman

(At an Investor interaction session at the IMF's headquarters few days ago)

3. RBI stance and rate cuts provides conducive environment to manufacturing

- RBI has cut repo rate by 135 bps in 2019. The Latest MPC meet reduced the Repo rate for the 5th consecutive time to 5.15% (this time by 25bps) and RBI maintained its accommodative stance.
- The RBI's diktat to Banks to follow external benchmarks for loans would help in transmission of lower interest rates, resulting in much needed relief. These steps would improve liquidity and availability of credit.

In conclusion despite short term headwinds we feel deeply optimistic about the Indian economy in the long run and truly believe that great companies with well-run managements with Good & Clean business models will come out stronger. The steps taken by the government towards tax rationalization, to ensure availability of liquidity, push formalization and to protect domestic interest while encouraging foreign investment in India are positive. The coming months can see more efforts to get the economy back on track. In the near future negotiations surrounding RCEP[1] trade agreements will be a key event to watch out for if successful.

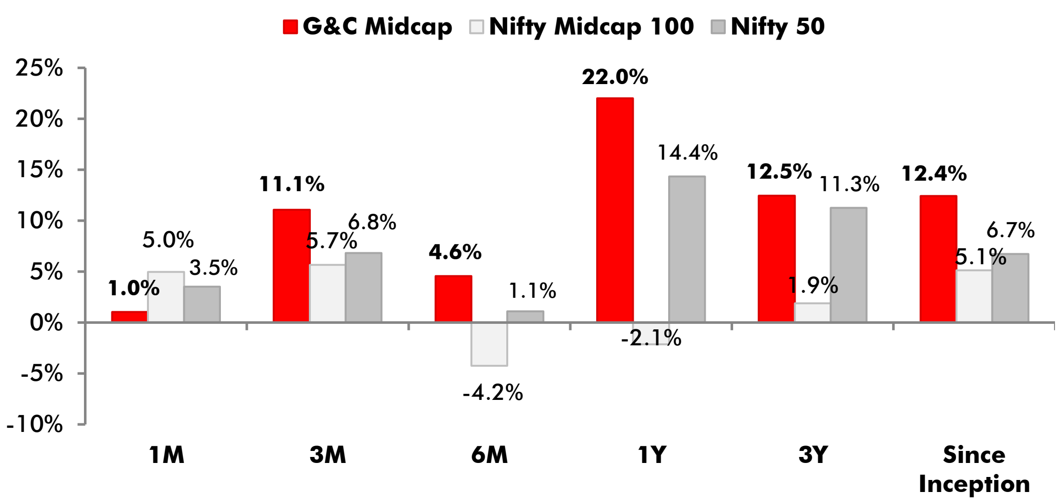
[1] Regional Comprehensive Economic Partnership

Ambit Good & Clean Portfolio

Ambit's Good & Clean strategy provides long-only equity exposure to Indian businesses that have an impeccable track record of clean accounting, good governance, and efficient capital allocation. Ambit's proprietary 'forensic accounting' framework helps weed out firms with poor quality accounts, while our proprietary 'greatness' framework helps identify efficient capital allocators with a holistic approach for consistent growth. Our focus has been to deliver superior risk-adjusted returns with as much focus on lower portfolio drawdown as on return generation. Some salient features of the Good & Clean strategy are as follows:

- **Process-oriented approach to investing**: Typically starting at the largest 500 Indian companies, Ambit's proprietary frameworks for assessing accounting quality and efficacy of capital allocation help narrow down the investible universe to a much smaller subset. This shorter universe is then evaluated on bottom-up fundamentals to create a concentrated portfolio of no more than 20 companies at any time.
- **Long-term horizon and low churn**: Our holding horizons for investee companies are 3-5 years and even longer with annual churn not exceeding 15-20% in a year. The long-term orientation essentially means investing in companies that have the potential to sustainably compound earnings, with this compounding earnings acting as the primary driver of investment returns over long periods.
- **Low drawdowns**: The focus on clean accounting and governance, prudent capital allocation, and structural earnings compounding allow participation in long-term return generation while also ensuring low drawdowns in periods of equity market declines.

Exhibit 9: Ambit's Good & Clean Portfolio performance update



Source: Ambit; Portfolio inception date is March 12, 2015; Returns as of Oct 31, 2019; since inception & 3Y returns are annualized returns. ***Returns are net of all fees and expenses***

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